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The Manufacturers Hanover
Economic Report

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A New Ball Game

Every so often, a major development takes place which has long-lasting effects on individuals, businesses, and governments. Sometimes its impact is immediately recognizable—but other times its meaning becomes clear only after considerable time has elapsed. These developments can take many forms. They may be economic, political, military, or technological in nature.

In recent years we seem to have been inundated with a variety of these changes. Politically, we have had to contend with assassinations and resignations of government leaders. Militarily, we seem to have shifted from fighting major wars to becoming involved in a variety of minor skirmishes. The technological revolution is still underway, but it has already produced major changes in the way business is run, information transmitted and analyzed, and money managed.

The economic sphere has seen its share of changes, too. Back in 1973, the U.S. and other countries adapted generalized floating foreign exchange rates. Also, the first oil "shock" occurred, in which oil prices were increased dramatically and oil supplies were restricted. The ramifications of these developments are still being felt. On the policy side, 1975 marked the beginning of intense Federal Reserve-watching by the financial community, thanks to the agreement between the Fed and the Congress regarding the publishing of annual targets for growth rates of the money supply. When, in 1979, the Federal Reserve began to place more emphasis on the money supply, Fed-watching grew even more intense and the financial markets became extremely jumpy. Fiscal policy has changed, too, with the passage of the Economic Recovery Tax Act of 1981 and the huge deficits that arose in its wake. We have yet to see the full impact of this development.

Now there is another change. I speak of leveraged buyouts. A leveraged buyout, or LBO, is the acquisition of a company by a buyer (usually with a part of the management team) that is financed to a substantial degree with borrowed funds secured by the firm's assets, based on its cash flow, or both. If the name is new, the concept isn't. This kind of transaction has been around for a half century or more. At that time, the deals were called "bootstrap financing."

The modern LBO first appeared in the early 1970s, when, in the wake of a depressed stock market, owners of privately held companies who wanted to take their money out of their company, sold out to a group including some of their managers put together in the form of an LBO. Later on in the decade, diversified companies began to sell off subsidiaries that were not living up to expectations, either from the point of view of growth or long-term strategies. Frequently, the buyers for these operations were equity pools, which brought in their existing managers who also put up small amounts of money.

LBOs Improve Efficiencies...

It soon became apparent that companies were run differently under these new arrangements. Owner-managers seemed to run the companies much more efficiently than they had when they were drawing a salary and managing the company on behalf of absentee owners. And that brings me to some of the changes that have either already occurred as a result of these LBOs, or are likely to occur in the future.

Perhaps the first thing that a manager-owner feels he must do upon taking over an LBO-financed company is to improve efficiency. Since he had to put up some of his own funds as part of the deal, he has a greater stake in the success of the company than he had before. Instead of being just a manager, he now has become a stockholder. And having an equity stake in the business, it is natural that he wants the business to be run as efficiently as possible. This is not to imply that publicly-held companies run by professional managers are not efficient; they certainly are and have contributed greatly to the growth of our economy and the improvement in our standard of living. However, I

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think you can appreciate the greater incentive that comes from being a manager-owner, when there is more at stake than simply general corporate objectives.

Some of this may already be apparent. Productivity, or output per hour worked, is increasing strongly. Although part of this rise no doubt reflects the normal gains in efficiencies that accompany the early stages of an economic recovery, part seems to go beyond the business cycle. To be sure, there has been more research and development, leading to technological changes which have spurred business purchases of computers, word processors, telecommunications facilities, and robotics for assembly lines. Also, the Economic Recovery Tax Act of 1981, which instituted the accelerated cost recovery of capital expenditures, deserves some credit. Nevertheless, my guess is that at least a small portion of the current improvement in productivity is also a product of the growing conversion to manager-owners.

...Reducing Price Pressures

Of course, greater efficiencies will lead to less pressure on prices. Indeed, because the manager-owner is even more concerned about sales levels, he might be extremely reluctant to raise prices. Increased productivity allows him to accomplish this objective. The result for the economy, of course, is less inflation.

Since labor costs comprise approximately two-thirds of business costs, any effort to hold the line on prices has to include smaller wage increases. I find it very interesting that wage settlements remain moderate even though labor markets have improved dramatically so far in the current recovery. Some of this must trace to labor's reduced bargaining power when a public company goes private.

A year and a half into this expansion finds the unemployment rate down faster than for this point in any previous recovery in the past 30 years. At the same time the employment numbers have risen faster than in any recovery since 1950. You would think that this would have caused labor to be more aggressive in its wage and salary demands—but it has not. The Labor Department tells us that major collective bargaining contracts settled in private industry continue to yield the lowest average wage adjustments in the history of this series. Combining these small wage increases with the ongoing strong trend in productivity leads to unit labor costs that are rising at their slowest pace since the mid-1960s.

Another aspect of efficiency that may already by showing up in the general run of statistics deals with inventory levels. As you will recall, inventories during the last recession were liquidated at a record pace. This liquidation kept up until about a year ago—well into the economic recovery—eventually producing the lowest overall ratio of inventories to sales in the postwar era. And although inventories have been growing since last summer, they still remain low relative to sales. No doubt such factors as the high real cost of money, the growing use of computers, and the lack of inflation psychology have motivated businessmen to keep inventories on the lean side. However, I would bet that the growing number of companies now run by their owners has played a part, too.

Lest you think that I am exaggerating the effect LBOs have on inventory levels, wage settlements, or inflation, I would like to point out that their impact may be far greater than may be discerned from counting the number of companies that have gone the LBO route compared with the total business population. This is because in most industries, when a low-cost producer emerges, it will affect others in that industry.

If the low-cost producer chooses to sell goods or services at the same price that other higher-cost producers do, that low-cost producer will obviously earn more money and either spur new entrants or encourage the others already in the industry to lower their costs so they can earn more, too. On the other hand, should the low-cost company choose to reduce its selling prices (or hold the line when others go up), it will also prosper, this time by increasing its share of market. Again, the onus will be on the others to match the price and cost structure of the most efficient firm.

In other words—while the number of companies that have gone the LBO route is relatively small, hence the number of products sold, the number of employees affected, and so forth is tiny, these LBOs may well have already had a disproportionate impact on the economy through their effects on their competitors.

Reported Profits Sacrificed...

One statistic yet to be materially affected by the trend to LBOs, but which certainly will be if this trend continues, is reported profits. Once a company goes private, speeding up cash flow becomes the high-priority item on the manager-owner's agenda, because of the need to retire the loans as quickly as possible. This can involve writing up the company's assets, which may have been acquired years ago at much lower prices, to present cost levels, making it possible to charge more depreciation based on the new, higher book value. Since depreciation is a subtraction from total revenues, this has the effect of lowering reported profits. Or it can involve the use of an NOL (net operating loss) partner

to shelter reported earnings, thereby also increasing cash flow.

Another subtraction from earnings is the interest that is paid on the debt incurred in the process of the buyout. Interest payments on borrowed money, as you know, are tax deductible, while dividends paid to stockholders are not. Therefore, the combination of greater depreciation writeoffs or an NOL partner, and larger interest payments will affect reported profits. And if reported profits are lower, so are tax revenues to various levels of government. Indeed, most companies in the early years following a buyout pay little corporate tax. These lower tax revenues may soon be more than just a statistic—they might affect the budget positions of various governments if they become more widespread.

Looking for other implications of the trend to LBOs, one can draw analogies to those privately held companies that have been around for quite some time. So far, most privately held companies have been small businesses. And it is a fact that small business has done better than big business in driving economic growth in recent years. Why are small businesses so successful? Very simple. A privately held company, having closer control over ownership, can implement long range goals to increase productivity and profits and can be managed with more sensitivity to business trends and the world market. Without the need to communicate company strategies to public stockholders, managers in privately-held comanies are under less pressure to produce quarterly results for stockholders. Thus they are freer to sacrifice present gains for longer range goals that will benefit the company.

...For Long Range Goals

Part of taking a longer range view involves quicker depreciation methods and frequent updating of technology, which, as noted above, is common for leveraged buyouts. Privately-held companies, without the need to explain short-run profit trends to shareholders, are quick to discard outmoded equipment in order to take advantage of the latest technological breakthroughs. Writing these off produces less profits—but not necessarily less cash flow—and of course, it makes the company more competitive from a longer-run standpoint.

Although a lot of today's lending to individuals, companies and countries is being made at floating rates of interest, the trend toward leveraged buyouts may decrease the economy's sensitivity to interest rates. This is because more and more LBOs are now carrying fixed rates of interest. This is being accomplished through swaps and options. Indeed, last year only 37 percent of all loans made domestically carried floating interest rates, down from 54 percent five years ago. One wonders if this reduced impact might not eventually force the Federal Reserve to rethink its monetary policy strategies and objectives.

It seems to me that a new ball game may be getting started—the kind of game that was first played when the U.S. economy was in its infancy. Then, companies were specialized, producing one product or a narrow line of products or services. There was no such thing as a conglomerate. Also, if one company wanted to buy another, such a transaction could only be consummated on friendly terms, since there were no public shareholders who could be attracted. It may well be that a continuation of this trend towards private ownership will at least slow the recent trend toward corporate raiders and their "greenmail" tactics.

A lot of criticism has been levied lately at corporate executives. It has been charged that they seem to be more interested in themselves than in the shareholders of the company for whom they work. At issue is whether these executives are still accountable to the company's owners. They are accused of lavishing substantial salaries and bonuses on themselves, as well as conferring such amenities upon themselves as luxury cars, corporate jets, and apartments. Boards of Directors, theoretically representing shareholders, are said to serve at the pleasure of managements.

These charges are, for the most part, not true. However, one thought comes to mind: Once managers become owners, they think and act like owners. Those who criticize corporate America because of the separation of management and ownership that characterizes the corporate structure should look more kindly on leveraged buyouts, if for no other reason than this.

On the other hand, LBOs have been criticized for the amount of debt involved and what might happen if interest rates rise sharply and the economy slows down. Indeed, some have called LBOs, the REITs (Real Estate Investment Trusts) of the 1980s. I would answer these charges by pointing out that, in addition to the trend towards fixing interest rates, many LBOs have cash caps which shield cash flow from the effect of rising rates through a supplementary borrowing facility. As for the REIT comparison, it should be noted that LBOs involve direct lending, rather than indirect, as was the case with REITs. Also, the REITs obviously involved only one industry—real estate—which made them extremely sensitive to economic and financial developments. LBOs cut across a wide variety of industry groups—if anything, making them *less* sensitive to the state of the economy.

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Economic Report

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Business Conditions Update

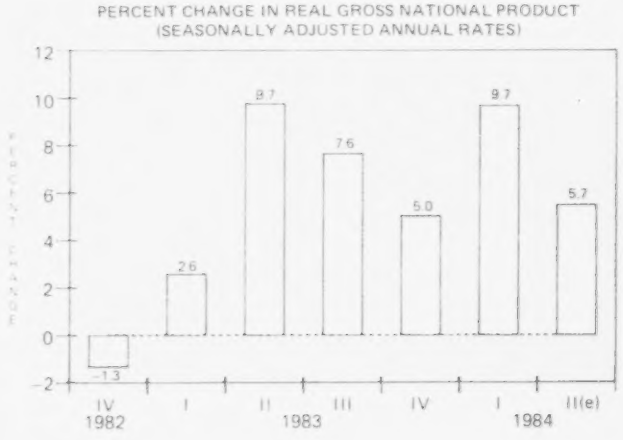
Midyear 1984 finds the U.S. economy in a state of transition. The rate of growth in the gross national product during the second quarter was less than that of the first—although not as little as economists had hoped (chart). On the other hand, inflation, as measured in the GNP accounts, slowed to an annual rate of only 2.8 percent from 3.9 percent in the first quarter.

Continued Growth...

The second quarter's still-strong rate of growth might be taken as a sign that another contraction in business activity is not far away. This is because interest rates are likely to move higher in such a strong-growth environment. And it was high interest rates that helped push the economy into the last recession.

A recession does not seem to be in the cards—at least for this year. This is because past recessions have also followed either excessive stockbuilding by the private sector, or spiraling inflation. In the case of stockbuilding, businessmen usually react to the discovery that they have more goods on hand than necessary by slashing production lines, laying off workers and reducing orders from suppliers. You can imagine how this could produce a recession by cutting into buying power. As for inflation, it eventually prompts the public sector to step on the brakes and restrain economic activity in order to bring the rate of inflation down.

Turning back to inventories, it must be acknowledged that there was a sizable buildup of inventories in the private business sector during the first quarter. Indeed, the increase in business inventories was a record for any calendar quarter both in nominal and in inflation-adjusted terms. What is more, the record is pretty firm on the contribution that excess stockbuilding makes to the business cycle: It peaks just at the end of an economic expansion. I don't think there is reason for worry this time, however. This is because the ratio of inventories to sales remains low. This ratio is not the lowest it has ever been, but it is far from levels reached in past business expansions just prior to the onset of recession. Furthermore, corporate executives are more aware of the need to keep inventories low—and more able to accomplish these objectives. The high real cost



of money and a decided lack of inflation psychology are two excellent reasons why companies are not likely to let inventories rise too rapidly this time around. And the growing use of computers enables many businesses to have a better idea of how orders are coming in, how sales are doing, where inventories are and how much inventory is needed to support a given level of sales.

Business people are lifting their sights when it comes to

NO REPORTS IN SUMMER

The Economic Report will not be published during July and August. The next issue will appear in September

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capital spending, however. And if they carry out their latest plans, the economy will get a boost in several ways. The Commerce Department's latest survey of corporate spending intentions suggests that such outlays will rise this year compared with 1983, after falling for two consecutive years. The projected increase, 15 percent, would be the largest percentage increase for any year since 1979, in nominal terms, and would exceed all annual gains in the past 18 years, when adjusted for inflation.

When businesses spend more on capital goods, it increases the demands on those industries that produce the capital goods. This means more employment, more materials and supplies, as well as financial and other services. You can see where this would have a ripple effect throughout the economy. Additionally, as the new capacity comes onstream, it adds to industry's ability to turn out goods without the shortages and bottlenecks which usually lead to inflation. And by replacing outmoded machinery and equipment with the latest technological developments, it makes industry more efficient, further helping to contain inflation.

...With Moderate Inflation

Notwithstanding the fears and predictions by economists, Wall Streeters and many others, inflation has remained tranquil so far in this economic recovery. Eighteen months into the current expansion finds prices, as measured in the GNP accounts, rising by the smallest percentage in over 20 years. Producer prices are up only half as fast as they have been at this point in previous expansions. What is more, there does not seem to be anything on the horizon to disturb this favorable comparison. Prices of industrial raw materials have been essentially level this year, and are still more than 12 percent below the peaks reached early in 1980. Farm commodities prices are also below their 1980 peaks. In addition, as noted in the March 1984 Economic Report, labor costs continue to grow moderately. Wage increases remain small while productivity gains are still healthy.

There are other factors contributing to the lid on inflation. The strong dollar has helped hold prices down by restraining exports and encouraging the inflow of lower-priced imports. This not only has resulted in more goods available for domestic consumption, it has made many U.S. companies very cautious in their pricing policies, lest they lose share of market to lower priced imported goods. Deregulation of oil, transportation, health care, telecommunications and the financial sector is also helping to restrain price increases.

One should not overlook the importance of monetary policy in keeping inflation at bay. In the past, the Federal Reserve would wait until it saw the whites of inflation's eyes before moving to tighten the supply of money and credit. Invariably, this would result in an overreaction—and a recession. This time around, the Fed tightened early—before inflation worsened materially. It is generally acknowledged that the Fed changed its posture about a year ago, following about ten months of aggressive ease. This shift in monetary strategy is one reason why interest rates remain comparatively high. But at least it has minimized the possibility of a liquidity-induced upsurge in inflation, near term.

The uptick in interest rates over the past year is beginning to slow economic activity. For one thing, with mortgage rates now close to 15 percent for a fixed-rate conventional loan, sales of single-family homes have begun to fall. If this continues, it will result in a rise in the number of unsold homes and will cause builders to cut back the rate of new housing starts. Obviously, this will have an impact on workers and suppliers to the building trades—not to mention sales of home furnishings. New car sales don't seem to be growing this year the way they did last year, and this may be due in part to higher interest rates besides shortages of popular models. Earlier this month, Detroit had only a 47-day supply of domestic cars on hand at then-current selling rates—well below the 60-65 day level that usually prevails at this time of year. Retail sales in May virtually flattened, while industrial production rose only one-third as fast as in April.

June, 1984

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1983				YEAR 1983		1984				YEAR 1984	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3171.5	3272.0	3362.2	3436.2	**3310.5**	**7.7**	3550.1	3624.8	3693.0	3762.4	**3657.6**	**10.5**
GNP: $72	1490.1	1525.1	1553.4	1572.5	**1535.3**	**3.4**	1609.3	1632.0	1647.6	1662.0	**1637.7**	**6.7**
% Change, Annual Rates	2.6	9.7	7.6	5.0	**3.4**		9.7	5.7	3.9	3.5	**6.7**	
Consumption	2073.0	2147.0	2181.1	2230.9	**2158.0**	**8.3**	2286.2	2341.5	2394.2	2436.8	**2364.7**	**9.6**
Durables	258.5	277.7	282.8	298.6	**279.4**	**14.3**	315.1	329.5	342.0	348.3	**333.7**	**19.4**
Non-Durables	777.1	799.6	814.8	825.0	**804.1**	**5.7**	843.2	861.1	875.1	888.2	**866.9**	**7.8**
Services	1037.4	1069.7	1083.5	1107.3	**1074.5**	**8.9**	1127.9	1151.1	1177.1	1200.3	**1164.1**	**8.3**
Investment	404.1	450.1	501.1	532.5	**472.0**	**13.9**	604.6	610.6	615.1	627.7	**614.5**	**30.2**
Non-Residential	332.1	336.3	351.0	374.0	**348.3**	**0.0**	385.7	400.7	412.1	422.3	**405.2**	**16.3**
Producers Durable Equipment	199.3	208.8	220.2	240.7	**217.2**	**5.2**	245.6	255.4	262.3	268.4	**257.9**	**18.7**
Structures	132.9	127.4	130.9	133.3	**131.1**	**-7.6**	140.1	145.3	149.8	153.9	**147.3**	**12.3**
Residential	111.3	128.4	141.5	138.8	**130.0**	**43.3**	147.8	154.8	154.5	152.2	**152.3**	**17.2**
Inventory Changes	-39.4	-14.5	8.5	19.6	**-6.5**		71.0	55.1	48.5	53.2	**57.0**	
Net Exports	17.0	-8.5	-18.3	-26.1	**-9.0**		-48.2	-71.0	-77.1	-80.1	**-69.1**	
Government Purchases	677.4	683.4	698.3	699.0	**689.5**	**6.2**	707.6	743.7	760.8	778.0	**747.5**	**8.4**
Federal Defense	194.4	199.4	201.2	206.3	**200.3**	**11.6**	212.7	217.8	223.0	227.6	**220.3**	**10.0**
Federal Civilian	79.1	74.3	76.9	67.8	**74.5**	**-6.0**	59.2	81.1	83.8	86.7	**77.7**	**4.2**
State & Local	404.0	409.7	420.2	424.9	**414.7**	**6.2**	435.7	444.8	454.0	463.7	**449.5**	**8.4**
Final Sales: $72	1505.5	1530.5	1549.7	1563.7	**1537.4**	**2.8**	1578.6	1608.8	1627.4	1640.1	**1613.7**	**5.0**
% Change, Annual Rates	0.6	6.8	5.1	3.7	**2.8**		3.9	7.9	4.7	3.2	**5.9**	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	218.5	**215.6**	**4.2**	220.6	222.1	224.1	226.4	**223.3**	**3.6**
% Change, Annual Rates	5.5	3.3	3.6	3.9	**4.2**		3.9	2.8	3.7	4.1	**3.6**	
PCE Deflator (1972 = 100)	210.1	212.5	214.7	216.1	**213.4**	**3.9**	218.1	219.5	221.6	223.8	**220.8**	**3.5**
% Change, Annual Rates	2.1	4.6	4.2	2.6	**3.9**		3.8	2.7	3.9	4.0	**3.5**	
Consumer Price Index (1967 = 100)	293.6	296.8	299.8	303.1	**298.3**	**3.2**	306.8	309.8	313.3	316.8	**311.7**	**4.5**
% Change, Annual Rates	0.3	4.3	4.2	4.4	**3.2**		5.0	4.0	4.6	4.5	**4.5**	
Total Personal Income	2657.8	2713.6	2761.7	2835.3	**2742.1**	**6.3**	2926.3	2977.4	3024.9	3076.5	**3001.3**	**9.5**
Disposable Personal Income	2255.9	2301.0	2361.7	2423.9	**2335.6**	**7.3**	2504.9	2547.6	2587.6	2630.6	**2567.7**	**9.9**
Savings Rate	5.4	4.0	4.9	5.2	**4.9**		5.9	5.3	4.6	4.5	**5.1**	
Employment Rate	55.6	55.9	56.6	57.0	**56.3**		57.5	58.1	58.4	58.7	**58.2**	
Unemployment Rate	10.4	10.1	9.4	8.5	**9.6**		7.9	7.6	7.3	7.2	**7.5**	
Indus. Production (1967 = 100)	138.5	144.5	151.8	155.5	**147.6**	**6.4**	159.8	164.3	166.9	169.2	**165.0**	**11.8**
Housing Starts (000)	1643.3	1690.3	1781.7	1698.7	**1703.5**	**61.3**	1968.0	1866.5	1767.9	1662.1	**1816.1**	**6.6**
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7220.7	**6792.1**	**18.0**	8266.7	8343.2	8374.8	8411.2	**8349.0**	**22.9**
Corporate Pre-Tax Profits	169.7	203.3	229.1	228.2	**207.6**	**19.2**	244.3	245.6	249.1	253.7	**248.2**	**19.6**
- Taxes	61.5	76.0	84.9	85.3	**76.9**		92.7	92.9	94.5	96.6	**94.2**	
Net Profits	108.2	127.2	144.1	142.9	**130.6**	**13.5**	151.6	152.8	154.6	157.1	**154.0**	**17.9**
- Dividend Payments	71.4	72.0	73.7	75.9	**73.3**	**6.7**	78.2	80.6	83.0	85.3	**81.8**	**11.6**
Undistributed Profits	36.7	55.2	70.4	67.0	**57.3**	**23.6**	73.4	72.2	71.6	71.8	**72.2**	**26.0**
+ Depreciation	242.2	255.4	270.7	281.4	**262.4**		288.3	297.4	307.3	317.4	**302.6**	
- Inventory Profits	1.7	10.6	18.3	6.3	**9.2**		12.5	16.5	22.9	25.5	**19.3**	
Net Cash Flow	277.2	300.0	322.8	342.1	**310.5**	**19.9**	349.2	353.2	356.0	363.7	**355.5**	**14.5**

The uptick in interest rates over the past year is beginning to slow economic activity. For one thing, with mortgage rates now close to 15 percent for a fixed-rate conventional loan, sales of single-family homes have begun to fall. If this continues, it will result in a rise in the number of unsold homes and will cause builders to cut back the rate of new housing starts. Obviously, this will have an impact on workers and suppliers to the building trades—not to mention sales of home furnishings. New car sales don't seem to be growing this year the way they did last year, and this may be due in part to higher interest rates besides shortages of popular models. Earlier this month, Detroit had only a 47-day supply of domestic cars on hand at then-current selling rates—well below the 60-65 day level that usually prevails at this time of year. Retail sales in May virtually flattened, while industrial production rose only one-third as fast as in April.

Well-balanced though it is, the current business expansion is approaching a critical stage. Because it wants to keep a lid on inflation and inflation psychology, the Federal Reserve is not fully accommodating all of the demands for money and credit. This is why interest rates have risen from their low points of a year ago and why they are likely to go up further over the balance of this year and into the first few months of 1985. Obviously, too high a level of interest rates will bring this expansion to a halt, producing another recession. Besides its impact on employment, sales and earnings, a new recession practically guarantees a reversal of the dramatic improvement that has occurred in the economics of country debt (Economic Report—April 1984).

The Fed's Dilemma

If the Federal Reserve tries to keep interest rates down by accommodating all of the borrowing needs implied by the demands for funds, then it runs the risk of generating a new round of inflation. And while some might argue that a little inflation might be just the ticket to help solve the country debt crisis plus one or two other problems, I am afraid that if the Central Bank were to adopt this posture, the ensuing round of inflation would not be modest. One could easily envision the rate of inflation going up beyond the peaks reached in 1980 if markets were to believe that the Fed has thrown in the towel and given up the battle against higher prices.

There is a way out, of course. It is for Washington to reduce its budget deficit, thus its claims on the nation's financial resources. No amount of legerdemain by the Administration or its supply side supporters can obfuscate the fact that it is the current and projected budget deficit by the Federal government that threatens to upset this well-balanced recovery. It does not matter what the Administration's beliefs are regarding the connection between its deficits and the level of interest rates, the value of the dollar, inflation psychology, monetary policy and the plight of the borrowing countries. What does matter is what the financial markets believe, for when day is done they prevail. And the markets are deeply concerned about the deficit—witness the high levels of real interest rates. It's time that the Administration recognizes this and gets down to some serious deficit-cutting before it becomes too late to avoid another inflation cycle, recession cycle —or both. H

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